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# LESSONS LEARNED AND EXPERIENCES OF RECENT MICROENTERPRISE PROJECTS IN DEVELOPING COUNTRIES

by

Richard L. Meyer

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Agricultural Finance Program
Department of Agricultural Economics
and
Rural Sociology
The Ohio State University
2120 Fyffe Road
Columbus, Ohio 43210-1099

## Abstract

Donor agencies have actively supported microenterprise programs during the past decade. Several evaluations have been conducted and identified their successes and failures. A particularly good evaluation was done by the U.S. Agency for International Development. This paper summarizes the highlights of this evaluation, identifies the characteristics of successful projects and discusses eight policy issues concerning microenterprise development.

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## INTRODUCTION

Considerable attention has been focused on rural nonfarm enterprises in recent years by donor agencies and development specialists. Micro and small scale enterprises have also been the subject of many recent studies. Undoubtedly, some of this interest is due to the growing realization that large scale, modern industrialization strategies of previous decades have failed to solve many problems of underemployment and poverty (Liedholm and Mead). In recent years, it has become popular to view support for microenterprises as being an effective way to stimulate the private sector's contribution to growth and equity objectives of developing countries. Nongovernmental (NGOs) and private voluntary organizations (PVOs) have become particularly active in support programs of credit, training and technical assistance for urban and rural small scale enterprises. Donor agencies have begun to channel a larger share of their financial support to NGOs and PVOs rather than through government agencies.

There is considerable debate about the appropriate way to provide support to microenterprises. Many programs advocate low interest rates and other subsidies to help start or expand businesses. Critics claim that such an approach may be doomed to the same failures as experienced by small farmer credit programs in the 1970s and 1980s (Adams and Von Pishke).

Several donor agencies have conducted evaluations of their experiences in supporting micro and small enterprises. These evaluations can be found in reports prepared by APRODI; Ashe and Cosslett; Boomgard; Carter, Innamorati and McCarthy; Dessing; European Investment Bank; International Labor Office; Jackelen; Webster (1990); and Webster (1991).[1] A common theme discussed in these evaluations concerns program sustainability because donors have been criticized for supporting many programs that cannot continue to operate after donor support ends.

One of the most active donors in microenterprise programs during the last decade has been the U.S. Agency for International Development (AID). In 1988 and 1989, AID undertook and published a major stocktaking of its experiences in microenterprise development (Boomgard). Although the data used are somewhat weak, generally this evaluation is more thorough and insightful than the others. Therefore, its findings are useful in raising issues about microenterprises in developing countries.

The purpose of this paper is to briefly summarize the AID evaluation, and utilize its findings to raise policy issues about microenterprise development. It is hoped that these general issues will be relevant for the situation that Chile faces as it tries to stimulate the development of micro and small enterprises. The next section of the paper will present the AID evaluation and the third section will discuss policy issues.

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[1] A summary of these evaluations can be found in Meyer (1991b).

## THE EXPERIENCE OF AID

The stocktaking evaluation represented a major effort by AID to evaluate what was learned about what works and what doesn't work in its microenterprise projects (Boomgard). It focused on identifying projects and programs with proven effectiveness in generating and sustaining developmental benefits, and in analyzing the factors responsible for their success. Throughout the study, microenterprises were defined as firms that employ 10 or fewer full-time workers.

By the mid 1980s, AID was involved in at least 87 active microenterprise projects or programs in 35 countries. A purposive sample of 32 projects and programs located in 20 countries was selected for detailed study in the stocktaking. They were selected because they targeted assistance to microenterprises, and some analysis of beneficiary impact was available. In almost all cases, the project or program either began its operations in the 1980s or AID's involvement with it began at that time. Data were obtained from existing evaluations and site visits to 10 countries. Seven programs were selected from Asia, including the large scale Indonesian BKK program, 11 from Africa, and 23 from Latin America. They are being implemented by PVOs, government agencies and credit unions. Some programs provide only credit to their beneficiaries, while others also provide training and technical assistance.

Three distinct approaches to enterprise development were identified in the study. The **enterprise formation approach** attempts to help highly disadvantaged groups or individuals from the survival economy develop viable businesses. Programs following this approach often serve a relatively large proportion of new entrepreneurs and offer a comprehensive range of services focused on the creation of rudimentary business skills, resulting mostly in income generation rather than in new employment.

The **enterprise expansion approach** tries to improve the performance of existing microenterprises. It is essentially minimalist because it emphasizes small improvements for many firms, often providing only credit. The graduation of firms into small enterprises is largely left to natural selection, rather than project effort.

The **enterprise transformation approach** actively tries to graduate entrepreneurs from micro to small enterprises, often by providing an integrated mix of credit, training, and technical assistance. The firms assisted are typically somewhat larger than those involved in the other two approaches so employment generation plays a relatively larger role. Both the formation and transformation approaches are transformation-oriented, and place heavy emphasis on technical assistance and training. The expansion approach, on the other hand, tries to support existing enterprises, and this accounts for the minimalist credit orientation.

Six of the sampled projects and programs were found to emphasize enterprise formation, 22 enterprise expansion, and 14 enterprise transformation. Because of multiple subprojects, the total number exceeds the total sample size. A relatively small number of programs in Latin America emphasize enterprise formation, while a relatively large proportion in Asia and the Near East fall in the expansion category. The sampled programs were evaluated on three criteria: beneficiary impact, cost-effectiveness, and institutional sustainability.

The principal results of the AID evaluation are summarized in Table 1. The enterprise expansion data are presented in columns three, four and five. Column three gives the results for these programs treated together. Since this group is heterogeneous, the results for the six programs which operated primarily as financial institutions are presented separately in column four, and the results for the remaining programs are summarized in column five. In several cases data are missing, and in other cases there was wide variance among the programs within a particular group. Therefore, some of the differences in mean values appear large but are not statistically significant, as noted in column seven.

Most microenterprise programs serve only a few hundred clients; the exceptions are the financial institutions that serve thousands. Women represent a significant share of total beneficiaries in all programs. The formation and transformation programs tend to serve a larger percentage of manufacturing firms compared to other types, but the differences are not significant. Average program costs also are higher, but not significant, for these programs as would be expected with the larger amount of training and technical assistance provided their clients.

The average loan size in transformation programs exceeded US$ 3,000 compared to approximately US$ 500-700 in the other programs. This finding suggests that attempts to graduate microenterprises to small scale firms requires a large enough change in the firm to justify a relatively large loan. The relative loan size can be seen by comparing average loan size relative to GDP per capita. The transformation programs provide loans that average ten times the average GDP per capita, while other programs provide loans roughly one to two times GDP per capita.

Most programs provide 25 to 45 percent of their loans to finance fixed assets. The financial institutions in the expansion programs, however, provide mostly working capital which is consistent with their objective of helping clients make marginal improvements in their businesses. By lending mostly working capital, these institutions also face less stringent staff requirements, so it is easier to operate large scale institutions reaching thousands of clients.

The data in the bottom three lines of Table 1 give some indication of the comparative cost-effectiveness and financial sustainability of the programs. Because of the modest services provided and their large scale operations, the average program cost is lowest for the expansion programs with an average of just under $0.50 per dollar lent. Transformation programs on average cost double that amount, while formation programs cost six times more. One good indication of a program's ability to recover costs is reflected in the interest rate charged on loans. The expansion programs charge real interest rates that average up to 25 percent, while the other programs have a large subsidy element because they only charge 0 to 3 percent. Even the relatively high rates in the expansion programs do not cover program costs however.

The challenge to recover costs is further complicated by loan delinquency and default. The programs report loan arrearages ranging from 16 to 24 percent on average. If only half of these arrearages actually result in losses, loan losses of 8 to 12 percent are still too high for most programs to sustain without continuous infusions of outside funds. The expansion programs come closest to meeting self-sufficiency, but generally the other programs are far it. Financial self-sustainability is closest to being achieved in the best managed programs which limit their assistance to low cost financial services, such as the BKK and KUPEDES programs in Indonesia. Importantly, it was observed that credit programs that strive to become self-sustaining, even when the goal is unattainable, generally perform better than those that expect continuing external support. Organizations that think of themselves as businesses that must survive on the basis of earnings behave differently than if they are not subjected to this market test.

The evaluation concludes that direct assistance programs that aim to improve the performance of microenterprises without attempting to transform them into more complex businesses have a better record of achievement than do more ambitious transformational programs. They typically provide small working capital loans with efficient screening, rapid disbursement and a reasonable assurance of the availability of larger loans upon repayment. The beneficiaries are poor, but not the poorest of the poor. Benefits of the programs are modest for each client, but increase the income of many clients rather than create large amounts of employment. The organizations implementing these programs adopt a businesslike attitude towards achieving a large volume of lending and operate in a market area large enough to achieve economies of size. The evaluation also identified important qualitative factors affecting institutional performance, such as a clear, unambiguous mission, strong leadership, well-trained and dedicated staff, good management information systems and an ability to adapt to changing circumstances.

## POLICY ISSUES IN MICROENTERPRISE DEVELOPMENT

The AID evaluation, along with the other evaluations cited but not discussed in this paper, raise several issues about microenterprise development. They are briefly summarized here to contribute to the discussion about microenterprises in Chile.

1. **How does the macroeconomic environment affect microenterprise development?** The donor evaluations frequently noted that the environment in which microenterprises function must be considered when designing a support project. But little concrete evidence was provided about how the economic environment affected the success or failure of the microenterprise support project, or the microenterprises it was designed to assist. It is argued that policies frequently are biased toward large scale firms and discriminate against small scale ones (Liedholm and Mead; Little, Mazumdar and Page). Few guidelines are offered, however, into specifically which policies may be most crucial in affecting performance, and whether or not support programs should be postponed if the environment is judged too unfavorable for small scale firms.

2. **What is the potential for micro and small scale enterprises in an economy?** There is considerable debate about the potential for small scale firms in an economy and whether or not it is economically efficient to assist them. On the one hand, Liedholm and Mead argue that they are efficient users of capital and labor. On the other hand, Snodgrass[2] argues that small firms in low income countries are reservoirs of surplus labor. Only a few have the potential for developing into medium and large firms, and it is difficult to identify them in advance. Policies that explicitly favor small firms, by providing subsidies through differential application of minimum wages, taxes, zoning, etc., can actually inhibit their growth into medium sized firms. Snodgrass recommended active government support for small scale firms only if it can be performance-based as was the case in Taiwan and South Korea. The challenge, of course, is to design a program that limits assistance to just those firms that merit it.

3. **Which type of approach to microenterprise development is most successful?** The AID evaluation concluded that the enterprise expansion approach had generally been more successful than enterprise formation or transformation. This approach attempted to make only marginal improvements in the firms assisted. A minimalist approach was also advocated; that is, assistance is largely limited to credit with only small amounts of training or technical assistance. This approach is based on a process of self-selection among firms rather than attempting to predetermine which ones are likely to be most successful. The critics of this approach, however, argue that many microenterprises need much more assistance than is provided by minimalist programs.

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[2] This paper is included in the DEVRES publication.

4. **What type of credit should be made available?** The minimalist approach argues that loans should be a) untargeted and b) used to finance working capital. Targeted credit programs imply that designers of the program know best what borrowers should do with their funds. This is a highly presumptuous implication, however, considering the great variability that exists among microenterprises. Untargeted credit programs, therefore, operate on the assumption that borrowers know best how to allocate their resources so the programs concentrate their efforts on simply providing a reliable source of loans. It is also argued that programs that target large, long-term investment loans for borrowers make a mistake by encouraging microenterprises to make large increases in the scale and scope of their operations which they may not be capable of managing. For this reason, many programs emphasize short-term working capital rather than investment lending.

5. **How can microenterprise support programs be designed to ensure their long-term sustainability?** Several factors contribute to sustainability. First, costs must be kept low by offering only a minimal set of services to participants; this factor helps justify the minimalist approach. Second, the scale of operations must be large. Thousands of microenterprises must be assisted, rather than merely hundreds as is frequently the case. Third, interest rate spreads must be set high enough to cover operating costs, default risks, and inflation. Advocates for microenterprises often argue that interest rates must be low, but surveys of entrepreneurs report that quick, efficient access is more important than low interest rates. Interest rates must be high in order to cover the costs of making small loans. Fourth, loan recovery must be high. Programs will not be sustainable unless they can keep their loss rate to 5 percent or less. It is impossible to raise interest rates high enough to compensate for a high default rate. Fifth, savings

mobilization needs to be emphasized, both as a way to provide financial services to microenterprises and to acquire financial resources that are independent of governments and donors.

6. **What is the appropriate role for NGOs or PVOs?** NGOs and PVOs have some obvious comparative advantages in assisting microenterprises. Usually they closely identify with poor people, they are field oriented so they may better understand problems faced by entrepreneurs, and they are often more committed to improving this strata of society. NGOs and PVOs, however, frequently face several challenges. Many are not operated in a businesslike manner, they often lack business and entrepreneurial skills, and many are poorly staffed and organized. Although they often hope to eventually become financial institutions, for many the best service they can provide in the short term is to act as intermediaries between program participants, banking institutions and governmental agencies. Over time, they can develop capacity to provide more complicated services.

7. **Is graduation of microenterprises a feasible objective?** Many specialized micro-enterprise credit programs aspire to graduate their participants into regular banking relationships, but the evidence available suggests that graduation rarely occurs. In highly subsidized operations, there are few incentives for graduation for either the participant or the program. The prospects for graduation should be somewhat greater when microenterprise programs assist participants to obtain commercial loans from formal financial intermediaries. The information gained by the intermediaries about the borrowers should contribute to the development of longer term commercial relationships. There may be scope, however, for some microenterprise programs to

graduate into financial institutions if existing financial institutions do not attempt to serve the sector.[3]

8. **What is the appropriate role for donors in microenterprise development?** International donor agencies are likely to be interested in microenterprise development for the next several years, so foreign funds will likely be available in many developing countries for microenterprise support programs. Donors can play a useful role. They can help spotlight the developmental role of the small scale sector, they can help transfer successful experiences among countries, and they can fund training and technical services. The role of donors in providing financial services is less clear. Microenterprises generally use little of the foreign exchange that donors provide and local financial markets are generally adequate to provide microenterprise loans. If donor funds are used to increase domestic credit supplies, care should be taken so that interest rates are not subsidized and that loans are not targeted to specific end uses that may be inconsistent with borrower objectives.

## CONCLUSIONS

There are great differences in donor funded approaches to microenterprise development, but there are at least five points of concensus that appear to be emerging. First, the donors are increasingly concerned about project sustainability. This preoccupation arises from the criticism that many donor supported activities either fail during the life of the project, or cannot reach a

[3] This possibility is discussed by Boomgard, but there appear to be few cases in which this has actually occurred.

self-sustaining level of performance, so they fail once donor support is terminated. Therefore, several evaluations seek to identify those factors that contribute to project sustainability.

Second, there appears to be a decline in donor concern about what borrowers use loans for and the impact the loans have on them. Some years ago, donors were heavily involved in targeting the end use of loans so that funds would be channeled into so-called productive purposes. There was also a concern about measuring the impact of the projects on the poor. Today, there is a greater appreciation of the difficulty in measuring impact because of the fungibility of loan funds. There appears to be greater acceptance now that a positive impact can be assumed if entrepreneurs value a program enough to borrow, repay, and become repeat borrowers.

Third, the macroeconomic environment in which small scale firms operate was mentioned in several evaluations as a factor that should be considered when designing a microenterprise support project. Few guidelines are provided, however, about what specifically should be evaluated in project preparation besides the general issue of policy bias towards large scale industries. The extreme view is that projects should not even be undertaken unless the macroeconomic environment is first improved.

Fourth, there appears to be consensus emerging about the characteristics of a successful micro and small scale support project. It should be minimalist providing few services besides loans, reaching thousands of beneficiaries, operating on a commercial basis with interest rates high enough to cover costs, and a strong effort to recover loans. Solidarity group lending is often advocated as a means to efficiently lend and recover loans. Emphasis is on targeting the poor as end users of loans, but not targeting the end uses. Loans should be directed towards enterprise expansion, rather than enterprise formation or transformation. Institutions to implement projects should be screened carefully, and many require considerable assistance themselves before they can efficiently operate loan programs.

Fifth, NGOs and PVOs are frequently advocated as preferred implementing institutions, but there is a concern about how many are actually capable of the task. Like government agencies, many require considerable strengthening because their strong advocacy and commitment to the poor is not a sufficient attribute for operating a sustainable program. A combination of government and nongovernment activities may prove to be the best approach in many countries whereby each can work in its area of comparative advantage.

Microenterprises can play an important role in developing economies. They can use underutilized resources, and they can provide employment and income to people not absorbed by larger size businesses. Microenterprises often represent the starting point for a firm that eventually becomes larger. The problems that microenterprises face should not be underestimated, however, as demonstrated by their high failure rates in many countries. It is not surprising, therefore, that commercial lenders find it difficult to serve this risky clientele, and why it is important to learn from the success and failure of specialized microenterprise programs. These experiences help identify ways that may contribute to making microenterprise projects self-sustaining.

Table 1

KEY RESEARCH FINDINGS

| Item | Enterprise Formation | Enterprise Expansion: Total | Enterprise Expansion: Financial Institution | Enterprise Expansion: Micro-Enterprise Program | Enterprise Transformation | Statistically Significant[a] |
|---|---|---|---|---|---|---|
| Number of projects | 6 | 22 | 6 | 16 | 14 | -- |
| Average Years in Operation | 3.7 | 4.0 | 7.3 | 2.7 | 2.3 | yes |
| Average Number of Annual Beneficiaries | 328 | 87,871 | 393,172 | 642 | 264 | yes |
| Average Percentage of Women Beneficiaries | 59 | 43 | 41 | 43 | 27 | no |
| Average Percentage of Beneficiaries in Manufacturing | 54 | 40 | 23 | 44 | 60 | no |
| Average Program Cost per Beneficiary ($) | 948 | 575 | N.R. | 575 | 2,549 | no |
| Average Loan Size ($) | 508 | 705 | 676 | 714 | 3,261 | yes |
| Average Loan to GDP per Capita | 1.3 | 1.2 | 2.2 | 0.9 | 10.2 | yes |
| Average Percentage of Fixed Assets Loans | 25 | 20 | 9 | 26 | 45 | no |
| Average Program Cost per Dollar Lent ($) | 3.24 | 0.46 | 0.51 | 0.43 | 1.08 | yes |
| Average Real Interest Rate | 3 | 23 | 17 | 25 | 0 | no |
| Percent of Loan Funds in Arrears (%) | 24 | 17 | 22 | 16 | 18 | no |

[a]Statistically significant at the 5 percent level.

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